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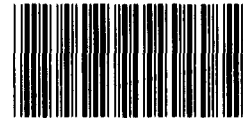
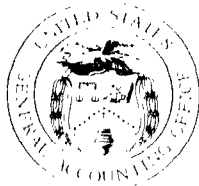
United States General Accounting Office

Report to the Chairman, Subcommittee
on Defense, House Committee on
Appropriations, House of
Representatives

July 1990

FINANCIAL MANAGEMENT

Analysis of Operating Cash Balance of the Defense Logistics Agency's Stock Fund



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Accounting and Financial
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July 5, 1990

The Honorable John P. Murtha
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

In an April 11, 1989, letter, you requested that we review and prepare separate reports on certain Army, Navy, and Defense stock fund pricing and refund practices. You made this request following our April 1989 report¹ to you on the Air Force Stock Fund, which discusses the budgetary impact of reducing the operating cash balance of that stock fund. In responding to your most recent request, we reviewed the operating cash balances of the Army, Navy, and Defense Logistics Agency and briefed your staff on the status of our work. This, the fourth in our series of reports on stock fund cash balances, presents information on (1) whether the Defense Stock Fund, managed by the Defense Logistics Agency, can operate at less than the currently required 11-day operating cash balance, (2) how refunds made to stock fund customers affected the 11-day cash balance, and (3) how stock fund customers used the refunds. Our reports on the Army and the Navy stock funds have been issued to you separately.²

Results in Brief

We found that from fiscal years 1988 through 1989, the stock fund's average month-end operating cash balances have ranged from 1.6 to 17.0 days of cash. We believe, similar to our earlier position regarding the Air Force, that the Defense Stock Fund has shown it can operate with less than 11 days of cash.

The Department of Defense, considering what it believes to be normal fluctuations in income received from customers and payments made to suppliers, established the 11-day requirement to ensure that a sufficient amount of cash was available to pay bills from suppliers. However, our analysis of Defense's operating cash balances for fiscal years 1988

¹Financial Management: Operating Cash Requirement for Air Force Stock Fund Can Be Reduced (GAO/AFMD-89-60, April 7, 1989).

²See reports entitled, Financial Management: Army Stock Fund Pricing and Refund Practices (GAO/AFMD-90-68, May 9, 1990) and Financial Management: Analysis of Operating Cash Balance of Navy Stock Fund (GAO/AFMD-90-59, May 2, 1990).

through 1989 showed that the average fluctuation in the cash balances from one month to the next was 4.4 days.

In addition, for the past 5 years, the stock fund has refunded about \$5.6 billion to selected customers. By making these refunds, the Defense Logistics Agency reduced the operating cash level below 11 days in fiscal years 1987 and 1989. Neither we nor Defense Logistics Agency officials were able to determine the ultimate disposition of the refunds because they were merged into other accounts.

Background

The Defense Stock Fund is one of four revolving funds in the Department of Defense used to procure material to support the military services. The Defense Stock Fund finances the procurement of over 2 million consumable items. To provide support to specific commodities, the Defense Stock Fund is subdivided into nine divisions: Construction, Electronics, General, Industrial, Clothing and Textiles, Medical, Subsistence, Fuel, and Base Operating Supplies. The management of items of supply for each division is assigned to a Defense Logistics Agency inventory control point. At the end of fiscal year 1989, the Defense Stock Fund had a total reported inventory value of \$12.6 billion and annual net sales of \$11 billion. The total assets held by the stock fund, consisting of inventory and cash, are referred to as the stock fund corpus.

The stock fund operates under a revolving fund concept, whereby it buys and holds inventory for sale to authorized customers, such as the military services. Sales of stock fund inventory generate cash that is used to replenish inventory levels.

Of the \$11 billion of net sales made by the stock fund in fiscal year 1989, about \$4.7 billion were due to the sale of fuels. According to Department of Defense officials, because the costs of fuels change frequently, it is very difficult to project the prices customers should be charged for fuels. For example, if actual fuel prices increase, the stock fund will be required to spend more money for fuel than projected. If actual fuel prices decrease, the stock fund will experience a surplus of funds. According to a Defense Logistics Agency official, fluctuating fuel costs are a primary reason for changes in operating cash balances.

To ensure that sufficient cash is available to pay incoming bills from suppliers, Department of Defense Regulation 7420.13-R requires that the stock fund maintain a certain level of funds with Treasury. Until

November 1989, when the House and Senate Appropriations Committees recommended that this balance be reduced to 5 days, Defense had used 11 days of operating cash to accommodate fluctuations in revenue received from customers and payments made to vendors. Such a cash level is achieved by adding a surcharge to the acquisition cost of inventory items when setting prices charged customers. For the Defense Stock Fund, the disbursements for 1 day are currently worth about \$32 million, for an 11-day total of about \$352 million.

While the stock fund obtains most of its funds by selling inventory items to its customers, it also receives appropriations from the Congress. These funds are intended to purchase war reserve material and inventory items to support weapon system modernization and modification. By designating funds for these items, the congressional committees attempted to gain a degree of budget visibility over certain stock fund purchases. These appropriations increase the corpus of the stock fund and are available to cover stock fund cash needs. Since fiscal year 1984, the Defense Stock Fund has received a total of about \$500 million in appropriated funds.

The stock fund has only a single cash balance consisting of both the operating and appropriated cash amounts. Therefore, when calculating the fund balance that is available to cover stock fund cash needs, Department of Defense officials can use the appropriated funds, to the extent they are available, to cover temporary cash shortages in the operating portion of the stock fund.

Objectives, Scope, and Methodology

Based on our April 1989 report on the Air Force stock fund, which discusses the budgetary impact of reducing the operating cash balance of the stock fund, you requested that we review certain Army, Navy, and Defense stock fund pricing and refund practices. In responding to your request, we reviewed the operating cash balances of these stock funds and briefed your staff on the status of our work. The objectives of this review were to determine (1) whether the Defense Stock Fund can operate at less than an 11-day operating cash balance, (2) how refunds made to stock fund customers affected the 11-day cash balance, and (3) how stock fund customers used the refunds. Our reports on the Navy and Army's stock funds have been issued to you separately. (See footnote 2.)

You also asked us to provide certain information regarding the use of refunds. In this report, the term "refund" describes two kinds of payments: (1) payments made under various statutory transfer authorities and (2) payments made to adjust the original price charged stock fund users. Although different legal authorities govern these two types of payments, we have used the same term to cover both.

To accomplish these objectives, we discussed with the Office of the Secretary of Defense and Defense Logistics Agency officials how stock fund (1) inventory prices and surcharges are determined, (2) operating cash balances are calculated, and (3) cash is returned to customers. We examined Defense Stock Fund budget documents and related accounting records. We reviewed congressional reports and legislation as well as Department of Defense and Defense Logistics Agency regulations concerning stock fund cash balances and refund policies. In addition, to determine if any material weaknesses had previously been reported on Defense Logistics Agency stock fund pricing and refund practices, we also reviewed the Defense Logistics Agency's Federal Managers' Financial Integrity Act reports.

Defense Logistics Agency officials could only provide us with year-end data on appropriated and operating cash balances for fiscal years 1985 through 1987 because the accounting system did not have complete month-end balances for those years. The officials were able to provide month-end balances for fiscal years 1988 and 1989. We did not verify the accuracy of the budgetary data, but we did analyze the monthly Defense Stock Fund cash balances.

We performed our work at the Office of the Secretary of Defense; Headquarters, Office of the Comptroller of the Defense Logistics Agency; and Defense Logistics Agency's Defense General Supply Center, Accounting and Finance Center, and Revolving Fund Budget Division. We conducted our work from May 1989 to March 1990 in accordance with generally accepted government auditing standards.

Stock Fund Operated at Less Than an 11-Day Operating Cash Balance

The Defense Stock Fund has operated with less than an 11-day operating cash balance. Defense Logistics Agency information shows that during fiscal years 1988 and 1989, stock fund monthly operating balances ranged from 1.6 to 17.0 days of cash. Furthermore, our analysis of the operating cash balances from fiscal year 1988 through fiscal year 1989 showed that the average monthly fluctuation was 4.4 days. In essence, the cash balances changed, on average, no more than 5 days,

which was within the 5-day cash target recommended by the House and Senate Appropriations Committees.

Five-Year Analysis of the Stock Fund Operating Cash Balance

From our analysis of Defense stock fund cash, we determined that Defense's fiscal year-end operating cash balances have been less than the 11 day requirement. Table 1 displays the 1985 through 1989 fiscal year-end balances and the average month-end balances and the range of the operating cash balances for fiscal years 1988 and 1989.

Table 1: Stock Fund Operating Cash Balances for Fiscal Years 1985 Through 1989

Dollars in millions				
Fiscal year	Fiscal year-end balance	Average month-end balance ^a	Range of month-end balances	
			High	Low
1985	\$1,344	\$ •	\$ •	\$ •
1986	1,198	•	•	•
1987	224	•	•	•
1988	498	260	498	48
1989	71	282	546	71

^aThe Defense Logistics Agency could provide us with only annual year-end balances for fiscal years 1985 through 1987.

Table 1 shows that except for 1988, the fiscal year-end balances have decreased from one year to the next. For the two fiscal years where we were provided month-end balances, the operating cash balance ranged from a low of \$48 million in 1988 to a high of \$546 million in 1989. To relate this information to the 11-day requirement, table 2 provides the same data as shown in table 1, but converts the dollar information to equivalent days. To determine the equivalent days of cash for each fiscal year, we used the Department of Defense formula of total stock fund operating expenditures divided by 360 days. The 1-day disbursement rate for fiscal years 1985 through 1989 was \$34 million, \$31.8 million, \$28.4 million, \$29.3 million, and \$32 million, respectively.

Table 2: Stock Fund Operating Cash Balances for Fiscal Years 1985 Through 1989 Converted to Equivalent Days

Fiscal year	Fiscal year-end balance	Average month-end balance	Range of month-end balances	
			High	Low
1985	39.5	•	•	•
1986	37.7	•	•	•
1987	7.9	•	•	•
1988	17.0	8.9	17.0	1.6
1989	2.2	8.8	17.0	2.2

Table 2 shows that the fiscal year-end balances for 1985 and 1986 were substantially higher than the 11-day operating cash target. In 1987, the fiscal year-end balance dropped below the 11-day target, and rose again above the 11-day target in 1988. The 1989 fiscal year-end operating cash balance went down to 2.2 days of cash. Defense Logistics Agency officials attributed these changes to fluctuations in the costs of fuel and refunds.

In our April 1989 report, we stated that the Air Force stock fund operating cash balance could be substantially reduced. By reducing the cash target below 11 days, the surcharge added to the selling price of inventory items should be reduced, thus lowering the prices the stock fund charges its customers by a corresponding amount. This, in turn, could result in a reduction to Defense budget authority.

Acting on our recommendations, in November 1989, the House and Senate Appropriations Committees recommended lowering the stock fund operating cash requirement from 11 days to 5 days which resulted in the Congress reducing the fiscal year 1990 Department of Defense budget by \$707.2 million. Furthermore, because stock fund customers should theoretically be able to purchase the same quantity of items at reduced prices, the customers' ability to perform their missions should not be adversely affected.

Changes in Stock Fund Monthly Cash Balances Have Been Less Than 5 Days

Our analysis of the operating cash balances for fiscal years 1988 and 1989 showed that the average monthly fluctuation was 4.4 days. The fluctuation in the monthly cash balances is a key measure in analyzing the needed level of the stock fund cash balance. In analyzing the monthly fluctuations in the operating cash balances, we adjusted the operating cash balances for refunds. As agreed with the Office of the Secretary of Defense and Defense Logistics Agency officials, refunds need to be added back to the operating cash balances because they are

not part of the normal stock fund process of income received from customers and payments made to suppliers.

We analyzed fluctuations, or changes, in operating cash balances for fiscal years 1988 through 1989. Of the 23 months of data available, the average operating cash fluctuation was 4.4 days. In addition, of the 23 months of data, there were 12 months in which cash increased; and 11 months in which cash decreased, with 8 of these fluctuations exceeding 5 days. Four months had cash increases over 5 days and 4 months had cash decreases over 5 days. According to a Defense Logistics Agency official, these fluctuations were generally due either to changes in fuel prices or to refunds.

Refunds Total About \$5.6 Billion in Last 5 Years

The Defense Logistics Agency has made substantial amounts of refunds from the stock fund to its customers—about \$5.6 billion since fiscal year 1985. Table 3 shows the refunds made during the year as well as the fiscal year-end operating cash balances after refunds, in dollars and equivalent days.

Table 3: Stock Fund Refunds and Year-end Operating Cash Balances for Fiscal Years 1985 Through 1989

Dollars in millions

Fiscal year	Refunds		Operating cash after refunds	
	Amount	Equivalent days	Amount	Equivalent days
1985	\$1,277	38	\$1,344	40
1986	1,042	33	1,198	38
1987	2,756	97	224	8
1988	39	1	498	17
1989	444	14	71	2
Total	\$5,558	183		

As table 3 shows, refunds made in fiscal years 1987 and 1989 reduced the operating cash balance below the 11-day requirement. For example, the Defense Stock Fund could have had an operating cash balance at the end of 1989 of 16 days instead of 2 days if refunds equivalent to 14 days had not been made. These refunds were made with various levels of congressional involvement and approval. The refunds were generally intended to offset budget reductions in the customers' accounts. When we attempted to determine how these refunds were used by customers, we found that the refunds had been merged with customers' appropriations and, therefore, could not be traced. As a result, neither we nor

Defense Logistics Agency officials could determine how the refunds were ultimately used other than for the general purposes of the appropriation which received the refund.

While we were not able to determine the use of all refunds, table 4 shows the amount of refunds the Defense Logistics Agency stock fund customers received by fiscal year, from 1986 to 1989.

Table 4: Amount of Refunds Stock Fund Customers Received From Operating Funds for Fiscal Years 1986 Through 1989

Customer	Fiscal year			
	1986	1987	1988	1989
Army	\$182.4	\$416.8	\$0	\$90.0
Navy	538.1	818.5	0	0
Air Force	273.3	1,472.7	0	189.3
Marines	34.3	27.1	0	0
Coast Guard	0	0	39.3	41.5
Defense Logistics Agency	14.0	20.6	0	92.0
Defense Agencies	0	0	0	31.2
Total	\$1,042.1	\$2,755.7	\$39.3	\$444.0

Over the last 4 years, the greatest amount of refunds were given to Defense stock fund customers in fiscal years 1986 and 1987. The major services, Army, Navy, and Air Force, were the recipients of over 95 percent of the refunds during this period. In fiscal year 1988, total refunds decreased significantly and then rose again in fiscal year 1989.

Conclusion

Between fiscal years 1987 and 1989, the Defense stock fund operating cash balance was often less than 11 days. During 1989, the House and Senate Appropriations Committees recommended the Department of Defense change its policy and lower the stock fund operating cash requirement from 11 days to 5 days. Our analysis shows that a 5-day cash supply is adequate and, as a result, we are not making any recommendations at this time.

As requested by your Office, we did not obtain written comments on a draft of this report. We did, however, discuss its contents with pertinent Defense and Defense Logistics Agency officials and have incorporated their views where appropriate.

Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time we will send copies to the Secretary of Defense, the Secretary of the Defense Logistics Agency, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others upon request.

Please contact me at 275-9454, if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix I.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Jeffrey C. Steinhoff". The signature is fluid and cursive, with the first name "Jeffrey" being the most prominent part.

Jeffrey C. Steinhoff
Director, Financial Management
Systems and Audit Oversight

Major Contributors to This Report

**Accounting and
Financial Management
Division, Washington,
D.C.**

Joseph Potter, Assistant Director, (202) 695-6922
John T. Leslie, Jr., Accountant-in-Charge
HeidiKitt Winter, Staff Accountant

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